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081504Z Dec 05

UNCLAS SECTION 01 OF 02 ANKARA 007210

SIPDIS

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E.O. 12958: N/A

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SUBJECT: Killing Off Inflation - Move to Formal Inflation
Targeting

1. (SBU) Summary: The Turkish Central Bank announced that it will begin formal inflation targeting in 2006, and announced a targeted inflation rate of 5% in 2006, and 4% each in 2007 and 2008. This marks another milestone in Turkey's quest for economic normalcy. Although not without risk, the move to formal inflation targeting represents another important nail in the coffin of Turkey's history of high inflation. End Summary.

Serdengecti Announces Formal IT

2. (SBU) In a December 5 press conference, Central Bank Governor Sureyya Serdengeçti announced details of the Bank's monetary policy for 2006, including the long-expected change to formal inflation targeting (IT), also called explicit inflation targeting. Although the Turkish Central Bank (CBRT) has been informally targeting an inflation rate as its primary indicator, until now the Bank has had some flexibility to consider other factors in setting monetary policy.

3. (SBU) The new system locks in explicit targeting of inflation as measured by change in the Consumer Price Index (CPI), changes the monetary policy committee from an advisory to a policy-setting role and lays out a more formalized and transparent policy-setting mechanism. The Central Bank has long been preparing for the move to formal IT, because of its successful track record in a growing number of countries and in keeping with IMF recommendations.

Move to IT Key Step on Turkey's Road to Price Stability

4. (SBU) The CBRT's announcement is a powerful manifestation of the progress it has made, under Serdengeçti's skillful leadership, in bringing down inflation. 2004 was the first year since the early 1970's in which Turkey's inflation rate was in single digits, with rates sometimes over 100% during the worst years of the 1990's. In four short years since the 2001 crisis, the CBRT's tight monetary policy, helped along by the GOT's tight fiscal policy, favorable global conditions, a strong lira and increased political stability, has enabled a gradual disinflation. For 2005, Turkey is on track to register CPI inflation slightly below the 8% target for the year.

5. (SBU) Serdengeçti has long told us privately that he could only move to formal IT once he was confident the disinflation process was well-entrenched: if inflation spiked under formal IT the CBRT could lose credibility and have few good policy options. Clearly, Serdengeçti now feels sufficient confident to move to formal IT. The lowering of inflation expectations, the Government's track record of fiscal austerity-including tightening fiscal policy in 2006-and the gradual build up in the Bank's inflation-fighting credibility have enabled the Governor to take the plunge into formal IT.

Wiggle Room from the "Uncertainty Band"?

6. (SBU) Indeed, perhaps because he fears being locked into a rigid target with no room for maneuver, Serdengeçti accompanied the announcement of inflation targets (5% in 2006 and 4% each for 2007 and 2008) and an "uncertainty band" of 2% in below and above the target in 2006, with subsequent years' bands to be announced later. Serdengeçti denied the band means the Bank is targeting a range, and said the Bank would be accountable to explain deviations from the target. At the same time, he explained that setting a band recognizes the large number of factors outside the Bank's control, such as a spike in oil prices or other external shock. Perhaps to counter accusations that

the Bank was targeting a path, Serdengecti also charted a quarterly "path" for inflation: 7.4% as of March, 2006, 6.5% in June, 5.8% in September and 5% by yearend 2006.

Reserve Build-up to Continue

17. (SBU) Serdengecti also announced that the Central Bank's program of Foreign Exchange purchase auctions would continue, with an increase in the daily purchases from \$15 million to \$20 million, with optional additional purchases of \$40 million instead of \$30 million. These increases reflect the Bank's agreement with the IMF on the desirability of continuing to take advantage of favorable market conditions to build foreign exchange reserves. Although, the Bank keeps increasing its reserves, the ratio of reserves to short-term debt remains low by international standards.

The Challenge in Meeting the 2006 Target

18. (SBU) Despite the Bank's impressive track record in recent years, many analysts believe the 5% 2006 inflation target may be difficult to achieve. Risks abound: higher oil prices, the potential for erosion of GOT fiscal discipline as elections draw near, ongoing price rigidity in the services sector--all could threaten achievement of the target. CSFB for example, is forecasting 2006 inflation of 6.2%.

Who Comes After Serdengecti?

19. (SBU) One risk cited by analysts which is increasingly discussed in the local press is what will happen after Serdengecti's term expires in March, 2006. Though the GOT could reappoint him--and this would be the lowest-risk option vis--vis potential market volatility--the betting is that the GOT will replace Serdengecti. If the AKP Government's track record holds true, they will select someone with closer ties to the Government, but will most likely choose amongst figures who would not upset the market. Serdengecti himself has told us he just privately he just wishes the Prime Minister would make a decision, well before the end of his term, so as to allow him to prepare for the transition if he is not reappointed.

Comment

110. (SBU) The announcement of formal IT is an important stepping stone to price stability in Turkey, a key nail in the coffin of Turkey's bad old days of high inflation. Serdengecti deserves tremendous credit for what he has accomplished. Risks associated with the end of his term and other pressures will mean an extra challenging year ahead for meeting the target.

Wilson